

THE RICHBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

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“In our highly complicated credit economy where every part of the system is connected with every other, directly or indirectly, by contractual bonds, every disturbance at one point spreads at once to others. If some banks — those nerve centers where innumerable strands of credit relations come together — are involved and become bankrupt, a wave of pessimism is bound to come: As a secondary phenomenon, a credit deflation is likely to be the consequence of general distrust and nervousness. All these things, upon which the traditional monetary doctrine builds its entire explanation, will make things even worse than they are, and it may very well be that this secondary wave of depression, which is induced by the more fundamental maladjustment, will grow to an overwhelming importance.”

— Gottfried Haberler, *Gold and Monetary Stabilization (Lectures on the Harris Foundation)*

THERE MUST BE SOME KIND OF WAY OUT OF HERE

“All Along the Watchtower” was a favorite anthem of the generation now fast-approaching retirement, if not already on the golf course (depending upon whether it was the Bob Dylan or the Jimi Hendrix version that they were listening to at the time). The Hendrix version, which is likely the more familiar of the two, opens with the following apropos lyrics: “There must be some kind of way out of here, said the joker to the thief, there’s too much confusion, I can’t get no relief... so let us not talk falsely now, the hour is getting late.” With residential real estate values 20–30% below their peak, and equity portfolios cut in half, the lyrics appearing as the title of this month’s essay may have a more poignant meaning than they did amid the purple haze and draft dodging four decades ago.

The Fed has already “trashed cash” by setting the policy rate near zero. As of the March Federal Open Market Committee (FOMC) meeting, the Fed has committed to buying Treasury bonds until yields fall further. Not only are yields on default-free bond investments at historical lows, but tax rates on dividend income are likely to rise, and even before that, companies are aggressively slicing dividends. Faced with the double-barreled shotgun of lost principal and minimal income-generating yields, baby boomers are undoubtedly seeking some kind of way out of here while dodging political jokers and Wall Street thieves.

Nevertheless, spring is in the air, and as we write, the S&P 500 has rallied well off its diabolical intraday low of 666, taking other equity markets around the world higher with it. A few straws are flying in the vernal breezes suggesting that the U.S. economy is “less bad” than it was during its free fall late in 2008. Not surprisingly, many professional investors have concluded not only must there be some kind of way out of here, but the way out has been identified and is already being implemented.

While we certainly agree there must be some way out here — indeed, there may be many ways, not all of them palatable to modern democracies — we doubt investors have fully considered the various consequences of the way out being pursued in the United States and elsewhere.

In this month’s *Richebächer Letter*, we briefly review the dynamics leading up to this period of financial and economic distress. We find some major imbalances are being addressed, including the reversal of over a decade of household deficit spending in the United States, yet we note that various balance sheet and asset price adjustments appear incomplete. In fact, it appears the ongoing adjustment process has initiated a sequence of intertwined complications for businesses and households, both on the income statement side and on balance sheets. These challenges emerging from the adjustment process pose questions for a rebound in asset prices that “we can believe in,” to borrow a well-worn campaign phrase.

We then highlight two uncanny parallels between the policy responses of President Herbert Hoover's administration to the Great Depression (Hoover was not simply quiescent, as popularly portrayed) and recent bailout efforts. Nevertheless, while a rather vigorous backlash against financial sector bailouts is developing, policymakers around the world are plowing further into fiscal stimulus and unconventional monetary policy to stave off the deflationary threat.

We find the level of nominal income in the United States did indeed fall in the last quarter of 2008, despite a dramatic expansion in the fiscal deficit and a reasonably good improvement in the trade balance. In the face of income and debt deflation risks, we continue to believe policymakers will pursue the easy way out with massive fiscal stimulus — China and the United States are already leading that parade. The question of placing Treasury debt issued with a massive federal deficit may be answered by the banking system, as both central and commercial banks have room to expand their Treasury holdings.

At the same time, this suggests further expansion of the money stock, and the Fed's recent pledge to add another \$1.2 trillion of assets to its balance sheet this year is a case in point. While flooding the system with liquid assets may achieve a revival of less-liquid asset prices, it may also pose the risk of eventual inflationary pressures and currency weakness. We suspect as more nations pursue the easy way out, the odds increase that the nature of fiat and credit currencies will become more apparent to investors. There is some kind of way out of here, but it may be a path strewn with both jokers and thieves demanding their due.

THE PATH TO DERAILMENT

We have noted in past letters that the financial balance approach has proven especially useful in identifying far-from-equilibrium positions with respect to spending patterns, credit flows and balance sheets, and this is no less true in analyzing the path to the 2008 derailment. Most macroeconomists focus only on the income statement aspects of the economy and related production results — GDP, unemployment and such. However, our experience, as well as that of Dr. Kurt Richebächer's, is that the monetary values, asset prices, credit flows and debt obligations can substantially influence real economic outcomes in a variety of ways. This is never more apparent than during the adjustment process following the bursting of an asset bubble.

From the financial balance approach, we know one of the most unusual and defining characteristics of the past two U.S. business cycles has been the persistent deficit spending of the household sector. Historically, the household sector was a net saving sector, with more income flowing into the sector than expenditures were flowing out. Net saving is in some sense a "natural" position for households, given job uncertainties, likely housing purchases, future college expenditures and eventual retirement.

THE RICHEBÄCHER LETTER

In Memory of Dr. Kurt Richebächer



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By the latter half of the '90s, however, the household sector had rejected a net saving position as it began literally consuming capital gains, realized or unrealized. Households began spending more than they were earning — indeed, governments are not the only sector in the economy that can deficit spend. More often than not, this deficit spending was financed by borrowing against appreciating asset values, as was directly the case with a home equity loan. As long as asset prices appreciated fast enough, as they appeared to do with the serial asset bubbles in recent years, many households believed they had found a way to evade the usual budget constraint imposed on their spending by their income flows.

Over time, sustained U.S. household consumption in excess of U.S. domestic production also drove the trade balance into an unprecedented deficit. As a result, the production structures of foreign economies, especially those in Asia, became increasingly locked into fulfilling U.S. (and Anglo-American in general, as the United Kingdom and Australia followed suit) household deficit spending.

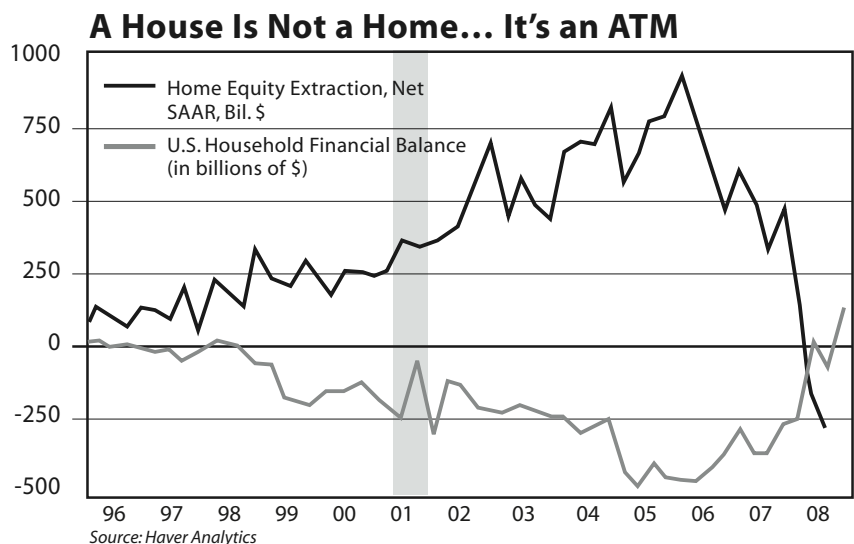
Some viewed this as a symbiotic relationship, declaring that a new global monetary arrangement they termed Bretton Woods II had spontaneously formed. Under this symbiotic relationship, trade surplus nations reinvested savings from their sales to the United States by accumulating U.S. Treasury and agency bonds, as well as other U.S. assets. This, in turn, was believed to suppress U.S. long-term interest and thereby encouraged more interest rate-sensitive spending by the U.S. households and businesses.

Yet to our mind, Bretton Woods II was doomed to follow in the footsteps of Bretton Woods I, hung by its own internal inconsistencies. If perpetual or serial asset bubbles could not be maintained in the United States, we surmised, in a paper published by the Levy Institute in the fall of 2006, that household deficit spending would eventually be forced to revert to a more “natural” net saving position. Foreign exports would suffer, and the “foreign savings glut,” as Fed Chairman Ben Bernanke depicted it, would turn into something of a drought. From a financial balance perspective, the foreign savings glut was to a great degree the counterpart of the gluttony revealed by U.S. (and other Anglo-American) consumers in the form of deepening trade deficits.

THE PAUSE THAT DID NOT REFRESH

In 2001, it turns out we were premature to anticipate a sharp reversal in the household financial balance as the New Economy equity bubble burst. A second asset bubble was called in to the rescue. The decline in equity values from early 2000 to March 2003 was in part offset by an appreciation of residential real estate values. Obviously, the Greenspan Fed had a large role to play as it dragged the policy rate down to 1% and held it there for far too long. But financial innovation, the erosion of lending standards and the distortion of incentive structures in the financial world also played a large role in the subsequent real estate boom.

Regardless, the tolerance, if not outright promotion, of serial or sequential asset bubbles allowed households to increasingly tap equity in their homes, and to then continue along their ever-deepening deficit-spending path. While many policymakers and investors asserted that mortgage equity withdrawal was used to pay down other, less tax-efficient forms of household debt, we can only note that the pace of home equity extraction appears to have quickened in the 2001 recession from the trend of the prior five years. In addition, oddly enough, the trough in the household financial balance arrived shortly after the



pace of home equity extraction peaked. A nearly \$500 billion annual pace of household deficit spending was achieved in 2005 and 2006, just as the home price appreciation hit its peak. Coincidental, perhaps, but it's more likely that mortgage equity withdrawal supported a good deal of the household deficit spending of this decade.

We also believe the household sector may have borrowed against rising real estate values to purchase financial assets. The personal saving rate out of income flows fell consistently through much of the past decade, yet the acquisition of financial assets by households well exceeded that of prior decades. How is it possible for a household to acquire financial assets in excess of the money it saves from its paycheck? With leverage, of course. Home equity loans may not only have funded consumer spending in excess of income, but they also may have financed leveraged expansion of household portfolios. If so, consider the margin call on such leveraged strategies when both home values and equity values fall precipitously.

A CONFOUNDED ADJUSTMENT PROCESS

If the past is prologue, what happens when we run the movie in reverse? In the last recession and recovery phase, disequilibrium dynamics in the economy were sustained by a housing bubble. This time around, the usual exit strategy of engineering another asset bubble has so far failed despite near-zero policy rates at the Fed and an unimaginable expansion of the Fed's balance sheet.

Instead, total assets of the household and nonprofit sector have dropped \$12.6 trillion since Q3 2007, with the bulk of that driven by a \$9.6 trillion decline in financial assets as equity values imploded late in 2008. The consequent shock to household balance sheets has been larger than anything witnessed since the Great Depression. Mortgage equity withdrawal has completely reversed as home values have breached loan values for some 20% of homeowners. What, then, are the implications of such drastic financial reversals?

First, as of the end of 2008, the household financial balance has sharply returned to a net saving position of nearly \$150 billion as new home sales have plummeted and consumer spending has finally been drawn below household income flows. Collateral values have obviously dropped in a dramatic fashion, reducing the capacity of households and firms to borrow. Lenders are impaired by rising losses on existing loans, as well as widespread holdings of "toxic assets" — essentially, structured finance instruments that either are bid well below their original purchase price, if not lacking a bid altogether. Lenders are accordingly highly risk averse, preferring to hoard liquid assets in lieu of new lending, and desperately trying to figure out how to raise capital to reduce the prospects of insolvency. Large dividend cuts have been a favored method of conserving capital of late.

Households have lifted their gross saving rate from near zero to 5% over the past several quarters as they realize they cannot count on capital gains in real estate or equity holdings to carry them into retirement. Two severe bear markets in equities in one decade, and the sharpest deflation in home prices since the Great Depression, are bound to leave their mark on household portfolio preferences. No doubt, many households realize that their wealth holdings must be rebuilt the old-fashioned way, namely by saving out of income flows.

With households ceasing to deficit spend, the pace of credit growth to the household sector has completely reversed, and households are net extinguishing debt. A reduction in household debt outstanding has never been witnessed in any prior post-World War II business cycle. We do not believe policymakers and investors have quite grasped the significance of this unusually large shift in household borrowing behavior, yet we do believe deleveraging is the appropriate response.

Net household saving is up, yet net acquisition of financial assets has fallen dramatically. Household debt reduction has become the more urgent priority. Equity mutual fund redemptions are at unprecedented levels, with the proceeds from these sales still being parked in money market mutual funds yielding next to nothing. Thus, deleveraging of household balance sheets impacts the real economy and money incomes through reductions in consumer spending. Deleveraging also weighs on asset prices as households shift their portfolio objectives toward debt reduction, loss avoidance and capital conservation and away from leveraged long positions in risky, less-liquid assets like housing and equities. Against the backdrop of high private debt loads, these twin adjustments in

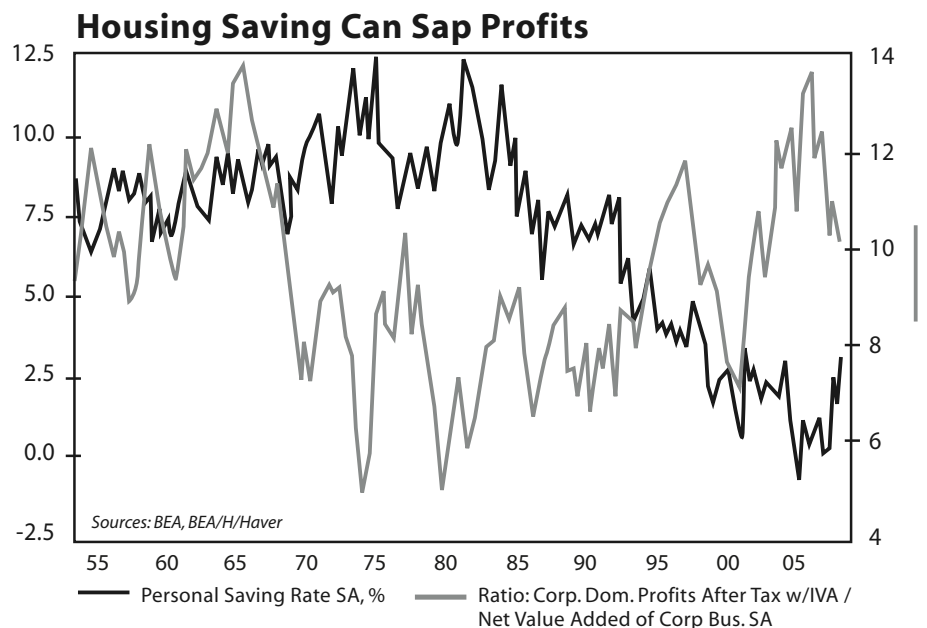
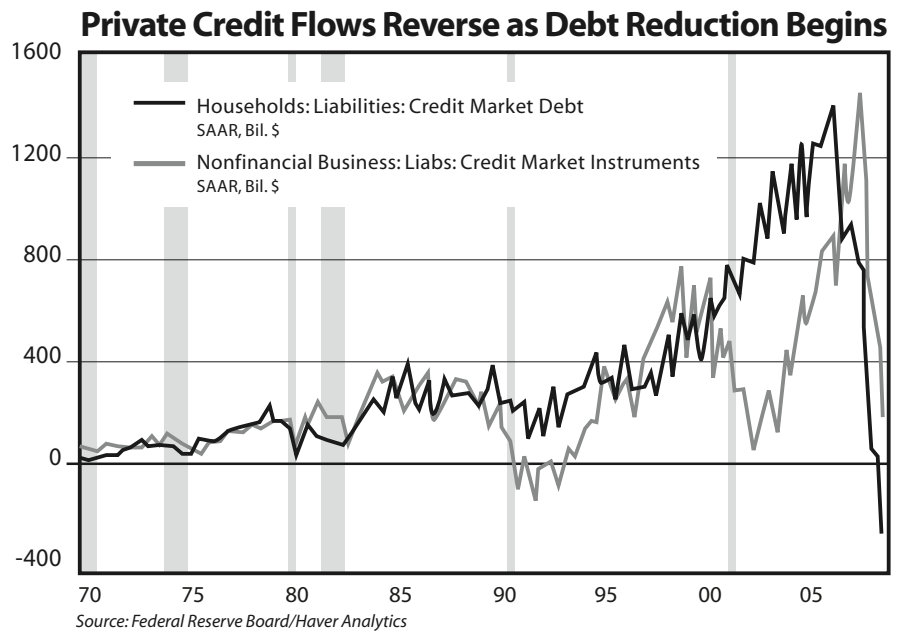
product and asset markets can feed a debt deflation process along the lines that Irving Fisher depicted in the early 1930s.

Second, as households react to the wealth destruction by raising their saving rate and paying down debt, business profit income flows are reduced and profit margins are squeezed. Since wages and salaries are a cost of production to businesses, a higher household saving rate means businesses recoup less of their expenses in the form of revenues from sales. If firms are not ramping up capital spending at the same time household saving is increasing, profits will fall short of expectations.

In general, though, periods of rising personal savings rates are often accompanied by periods of corporate profit margin compression. Without offsetting sources of business revenue from capital spending, trade or fiscal policy, firms may face what Chairman Bernanke calls an adverse feedback loop. Households save more, reducing business revenues and profits. Weaker profitability leads to lower planned production levels, lower employment and cancellation of capital spending plans.

Note how this sensible reaction of the business sector to weaker-than-expected profit signals can complicate the ability of households to reduce their debt-to-income ratio. Business layoffs undermine household income growth, and, in fact, wage and salary income growth has begun to drop on an annualized quarterly basis over the three months of November 2008–January 2009. Not only does a wage and salary income contraction require a deeper cut in consumer spending to achieve any desired level of personal saving, but it also makes it more difficult to reduce the household debt-to-income ratio if the denominator, after-tax personal income, is falling as well.

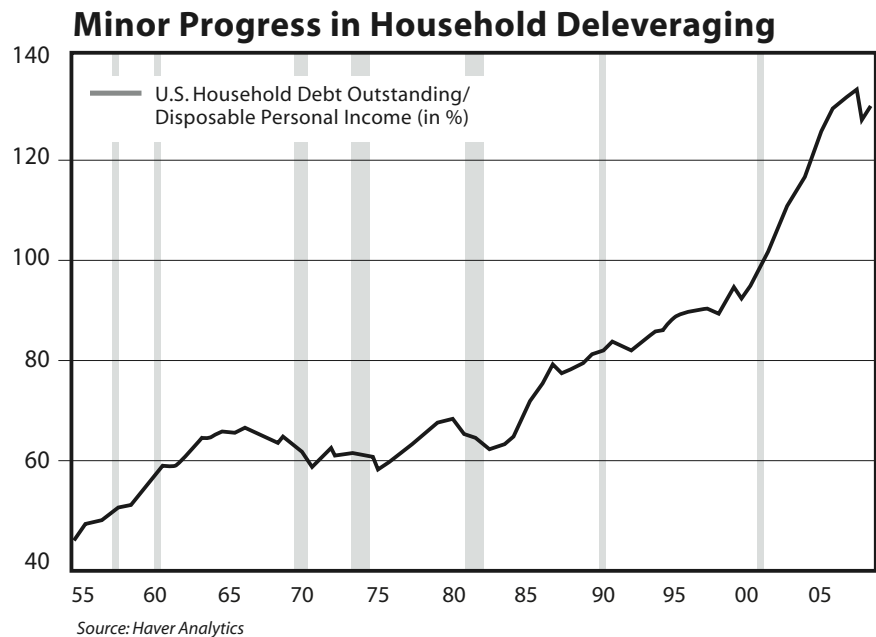
We must acknowledge some minor progress has been made in reducing the household debt-to-income ratio in recent quarters despite the onset of wage and salary income deflation in Q4 2008. Last month's *Richebächer Letter* walked through one plausible scenario depicting the degree of household saving required to return the household debt-to-income ratio to its pre-housing bubble trend. Our conclusion was that even allowing for only one year of personal income contraction, households would need to reduce spending out of their income flows by \$400 billion per year over the next three years to simply return to



the pre-housing bubble leverage trajectory.

This highlights the relevance of the debt deflation process that Fisher warned about more than seven decades ago. Attempts to reduce private debt loads can be thwarted if they also feed back to reduced private income generation. Attempts at private-sector deleveraging can lead to higher, not lower, debt-to-income ratios, unless private expenditure reductions are sufficiently offset by an improving trade balance or fiscal stimulus. During the Great Depression, the sharpest rise in the U.S. debt-to-income ratio came after depression dynamics set in, not before, as private income levels collapsed.

Third, it is true that as households reduce their spending, the trade deficit will tend to shrink as imports contract. Many economists have held that the trade deficit is the twin of the fiscal deficit. While this can be the case under certain conditions, our analysis indicates that, over time, the more likely twin of the trade deficit is household deficit spending. After all, a good deal of the imports are consumer goods. Reverse household deficit spending, and you have a good chance of reducing the trade deficit, as we can see in the progress made during the past year in both balances. In fact, over the past year, the surging budget deficit has not prevented the trade deficit from responding to the reversal of household deficit spending.



While a reduced trade deficit cushions the blow to private income, as less U.S. spending is drained abroad to fuel foreign income growth, it also tends to drag export-dependent economies into the maelstrom. In the spring of 2007, we identified how this pointed to a flaw in the global decoupling view that was once quite popular among investors. In recent letters, we have gone so far as to state since Asia essentially became the production platform for global tradable goods, especially consumer goods, much of the production adjustment can be expected to hit Asian economies — precisely the opposite of the of the global decoupling view. In the extreme, one might describe Asia as the next Detroit.

The tremendous capacity installed in Asia and elsewhere over the years to fulfill U.S. household deficit spending becomes increasingly redundant unless foreign economies can find other trading partners, or unless they can sufficiently stimulate their own domestic demand. In the quest for the former, competitive currency depreciations can break out as countries attempt to make their tradable goods relatively cheaper than those of other exporting nations. We can see this in Korea and to a lesser extent in Japan already. Eastern Europe has also been depreciating, although this is more a reflection of the capital flight from the region than a conscious policy decision to gain market share in tradable goods.

Fourth, as domestic firms face profit shortfalls, and as the declines in asset values reduce their net worth, business sector borrowing is also curtailed. Over the past three business cycles, business debt has been especially facilitated toward large share repurchases. Share repurchases shrink the supply of equity shares outstanding, and thereby act as an equity price-boosting mechanism. Nearly 5% of the equity market capitalization of the nonfinancial business sector was mopped up in share repurchases in 2007 — rivaling the share shrink accomplished during the limited buyout boom in the late '80s. By the end of 2008, share repurchases were closer to 3% of outstanding market cap,

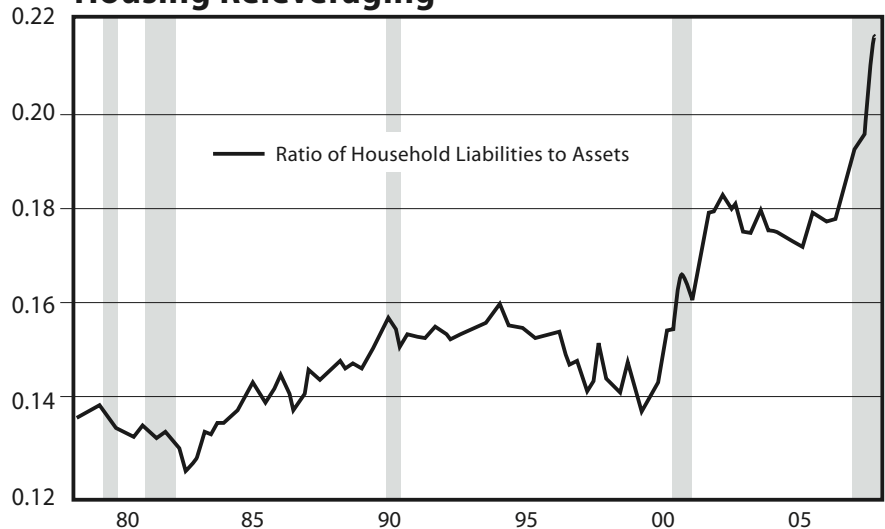
and we believe these will go to zero fairly quickly in 2009. As firms find themselves financially constrained to the point they are cutting dividend payments, share repurchases appear to be a luxury, thereby removing what otherwise could act as an important price support mechanism for the equity market.

Finally, as asset prices fall, household leverage ratios rise. Just as we saw after the last cascade in equity values following the bursting of the New Economy bubble, once again, the household liability-to-asset ratio has surged. Households seeking to deleverage by lowering their liability-to-asset ratio may face a moving target until asset prices stabilize. In fact, as equity prices have fallen faster than real estate prices in recent quarters, the share of household portfolios in real estate has gone up — an outcome we doubt reflects household intentions given the 20–30% declines in this asset class of late.

In the opening quote, Gottfried Haberler highlights how the interconnections of credit flows, income flows and balance sheet positions across an economy can be a source of contagion effects once solvency issues arise. Haberler recognizes the adverse shift in perceptions can lead to a credit deflation — that is, a fall in credit outstanding, as is now evident in the U.S. household sector, and will soon arrive in the nonfinancial business sector as well. Both lenders and borrowers hunker down into a fetal crouch following the primary wave of a reversal in investment spending — this time, residential investment or housing, Haberler identifies “a secondary wave of depression” that results from the ensuing consumer retrenchment.

In the above analysis, we have traced out how this secondary wave is presenting itself this time around in the following four interwoven strands: (1) a reversal of household deficit spending to a net saving position on the shock to household wealth; (2) a compression in business profit margins as the household saving rate rises; (3) a reduction in the stimulus to foreign economies as the trade deficit shrinks on the reduction in household spending; and (4) an unintended rise in household liability-to-asset ratios, another measure of leverage, as falling profitability has reduced equity values. The secondary wave has indeed mounted into a global tsunami this time around, and naturally, policymakers are scrambling to reinforce seawalls and allocate the available lifeboats.

Falling Asset Prices Yield an Unintended Housing Releveraging



Source: Haver Analytics

WHEN HISTORY RHYMES

How, then, can the U.S. economy break out of these various adverse feedback loops — as Chairman Bernanke refers to them — that have developed between asset markets, spending behaviors of businesses and households, and investor and bank portfolio preferences? From an Austrian School point of view, the answer is that the assumption behind the question is patently wrong. Any interference in price adjustments, especially relative price adjustments, will simply prolong the agony of any economic or financial adjustment that may be required. In the worst case, necessary adjustments, particularly in the structure of production itself, will be deferred until the next business cycle downturn, at which time they will pose even greater challenges. The feedback loops are not adverse from an Austrian viewpoint, but rather utterly necessary to purge the system of its prior distortions.

For example, readers familiar with Murray Rothbard’s book *America’s Great Depression* will notice some remarkable historical similarities in the policies employed to address the current financial crisis. Rothbard in

particular attacks the popular perception that President Hoover twiddled his thumbs while the Great Depression was deepening. Rather, a wide range of policy interventions was unleashed on the economy and financial markets, including the Reconstruction Finance Corp. (RFC), under Hoover's active endorsement. Rothbard characteristically pulls no punches in his assessment of the appropriateness of these interventions in market mechanisms.

On all other aspects of the Hoover New Deal, the president blossomed, rather than faltered. The most important plank in his program — the RFC — was passed hurriedly in January by the Congress. The RFC was provided with government capital totaling \$500 million, and was empowered to issue further debentures up to \$1.5 billion...

For the first five months of its life, the lending activities of the RFC lay shrouded in secrecy, and only determined action by the Democratic Congress finally forced the agency to make periodic public reports, beginning at the end of August. The bureaucratic excuse was that RFC loans should, like bank loans or previous National Credit Corporation (NCC) loans, remain confidential, lest public confidence in the aided bank or business firm be weakened...

Some \$264 million were loaned to railroads during the five months of secrecy. The theory was that railroad securities must be protected, since many were held by savings banks and insurance companies, alleged agents of the small investor. Of the \$187 million of loans that have been traced, \$37 million were for the purpose of making improvements, and \$150 million to repay debts. One of the first loans, for example, was a \$5.75 million grant to the Missouri Pacific to repay its debt to J.P. Morgan and Company...

One of the main enthusiasts for this policy was Eugene Meyer, on the grounds of "promoting recovery," and, frankly, "putting more money into the banks." But this "promotion of recovery" really meant that the taxpayers were expropriated, and their money transferred by coercion to a few banks, notably J.P. Morgan and Company, and Kuhn, Loeb and Company. The extent of Meyer's humanitarianism in this affair may be gauged from the fact that his brother-in-law, George Blumenthal, was a member of J.P. Morgan and Company, and that Meyer had also served as a liaison officer between the Morgan firm and the French government..."

As we write, the bailout of AIG is generating widespread political outrage for several reasons, not the least of which is that the credit default swap (CDS) operation appears to be a black hole of ever-escalating losses. The primary controversy involves the use of public bailout funds to settle AIG's CDS obligations. CDSs are used to hedge against defaults on bonds already held in a portfolio, or, alternatively, to speculate on the likelihood of a bond defaulting.

AIG's CDS operation essentially provided insurance to bond investors without setting aside sufficient reserves to fulfill these contracts under the full range of plausible outcomes. Government bailout funds were subsequently used to fulfill the settlement of these CDS contracts, but Fed Vice Chairman Donald Kohn refused to release a list of the counterparties benefitting from these settlements before Congress. The list of counterparties apparently includes many Wall Street houses and foreign broker/dealers as well, with none other than Goldman Sachs at the very top of the list of recipients.

We have yet to hear Treasury Secretary Timothy Geithner spin this transfer of public funds as beneficial to the nation for "putting more money into the banks," but the shades of Eugene Meyer's RTC, with its secrecy and self-dealing, are written all over the AIG deal. Add to this the second controversy of AIG's bonus payouts, ostensibly to reward and retain the senior management who allowed the CDS debacle to brew on their watch at AIG, and you have all the ingredients for a bailout backlash that cuts across the usual political divisions in the United States.

Last month, we pointed out in *The Richebächer Letter* that the urgent objective of policymakers to get banks lending again might be somewhat misplaced. While we have no doubt that there are some households and firms (especially small businesses) that may be very creditworthy but are still unable to obtain a bank loan, we concluded in the aggregate, given the level of default and delinquencies reported even before the unemployment rate spiked

through 8%, reduction of private debt loads might be a better policy objective than forcing renewed lending by banks. This possibility has yet to cross the mind of Congress, yet Congress has also failed so far to find a way to force bank lending. Not surprisingly, Rothbard identified a similar misguided policy priority during the Great Depression:

The banks also received their share of Hoover's ire for their unwillingness to expand in those troubled times. The New York Times reported on May 20 that Hoover was "disturbed at the apparent lack of cooperation of the commercial banks of the country in the credit expansion drive." In short, the "banks have not passed the benefits of these relief measures on to their customers." The anger of the inflationist authorities at the caution of the banks was typified by the arrogant statement of RFC chairman Atlee Pomerene: "Now... and I measure my words, the bank that is 75% liquid or more and refuses to make loans when proper security is offered, under present circumstances, is a parasite on the community.

History may not repeat itself, but it does appear to offer a catchy little rhyme now and then. The rhetorical pitch has yet reach the level of Pomerene's elegance, but such "cast the money-changers from the temple" oratory will no doubt become increasingly appealing to those politicians trying to capitalize on the growing bailout backlash, which, if we are not mistaken, has a distinctly Austrian flavor to it.

PRICED TO PERFECTION?

Prior Richebächer Letters have detailed the theoretical reasons why a purely Austrian solution may be difficult to achieve. These include the arguments that (1) interest rates may not be the price that adjusts in order to equilibrate savings and investment; (2) large, sustained declines in durable asset prices may aggravate excess supply conditions, especially if the durable assets are financed with debt; and (3) attempts by households to increase saving may be thwarted if they are not met by rising business investment, thus leading to a decline in private incomes as the primary adjustment mechanism. Each of these strands can be seen to play a role in the debt deflation dynamics depicted by Fisher, although he did not necessarily make them explicit in his rendition. We will not repeat these debates here, although upon request, we would be happy to refer you to the prior letters in which these views are developed.

For those still unpersuaded by the arguments put forth along these lines in prior issues, consider the following middle ground offered by economist Hy Minsky as he discussed the possible stabilizing influences of price adjustments at the macro level in his 1980 essay "Money, Financial Markets and the Coherence of a Market Economy." Remember, like the Austrian School, and like J.M. Keynes himself, Minsky proceeded from an investment-driven model of economic growth and the business cycle:

Investment demand depends upon long-run expectations. The question is whether the market adjustments induced by less than full employment will always affect long-run expectations so that the demand for investment increases... Falling money wages, interest rates and markups in the production of investment goods may improve longer-run profit expectations so that investment demand increases, or they may be accompanied by such a fall in the current market price of capital assets and current profit flows that longer run profit expectations deteriorate...

In the years of the great contraction of 1929–33, it seems clear that the responses of labor, product and financial markets to unemployment, excess supply and difficulty in meeting financial commitments did not combine to improve expectations. Falling wages and product prices, by increasing the burden of cash payment commitments due to existing debts relative to profit flows... lowered the long-run profit expectations of businessmen and bankers...

Thus, there are factors influencing effective demand in a capitalist economy that cannot be linked unequivocally to wage, price or interest rate rigidities... Only if the market reactions to unemployment change long-run expectations so that investment increases, and if market reactions to excess aggregate demand alter long-run expectations so that investment decreases, can the system be considered as self-equilibrating with its "equilibrium" in the neighborhood of full employment.

We recognize an Austrian response to the above is to reject the notion that prices are allowed to adjust freely enough in contemporary economies. Austrians would also be quick to remind us that debt liquidation is unfortunately the price that must be paid to purge a fiat or credit currency system of the distorting gap between credit created from thin air and the real saving pool of productive resources. Nevertheless, we believe Dr. Richebächer would heartily agree with Minsky's observation that profit expectations are of the essence for growth in capitalist economies, and we believe he warned enough about price deflation that he must have recognized it could increase private debt burdens enough to damage profit expectations. The ability of downward price adjustments in a recession to restore the economy to its warranted growth path therefore may be especially questionable if the private sector enters the recession with a heavy debt load.

THE BAILOUT BACKLASH

Charged debates have resounded through many decades on these issues, and we would not pretend they could be easily resolved in the pages of *The Richebächer Letter*. Following Dr. Richebächer's lead, we are prepared to be heretical enough to drag our pickaxe down into the mines of both Keynes and Mises, retrieving whatever gems we can find along the way, and mapping where the connecting tunnels have been hidden. The bailout backlash now building across the United States may be a sign that some aspects of the Austrian solution are being embraced by the general public. The public perceives the jokers on Wall Street are being aided and abetted by political thieves in Washington, D.C. The populace increasingly perceives a double looting is under way — the first by plutocrats on Wall Street and the second by kleptocrats in D.C. aiding their plutocratic friends on Wall Street. The new administration, upon which so many hopes have been pinned, may sink or swim depending upon how adept it is in managing the bailout backlash.

At the same time, we are practical enough to realize few modern democracies are likely to tolerate the hardship associated with full-blown debt deflation dynamics. The public, in other words, while taking a more decidedly Austrian turn of late with regard to financial sector bailouts, may, in fact, prove to be fair-weather Austrians, at best. Around the globe, fiscal and monetary policy initiatives are stepping up well beyond the normal range of responses as debt deflation fears spread. Following Dr. Richebächer's approach, we would argue it is important to anticipate the likely consequences of these responses. That the Swiss National Bank is actively trying to depreciate its currency and to purchase corporate debt should indicate we are not in Kansas anymore — far from it.

THE EASY WAY OUT

In a monetary economy, if one sector — say, the private sector — decides to raise its net saving, some other sector must be willing to increase its deficit spending. Otherwise, the desired saving of the private sector will not be achieved and nominal, or money, incomes will fall. As a practical matter and as an accounting reality, for every ex-post net saver, there must be a net deficit spender. When the private sector desires to net save more money, the fiscal balance must move into a deeper deficit or the trade balance must move into a reduced deficit (as a U.S. trade deficit is equivalent to foreign net saving), or some combination of the two. If desired private net saving exceeds the actual trade and fiscal balance changes during a period of time, the first consequence is that realized income flows will adjust downward, often through profit shortfalls.

During Q4 2008, nominal GDP did decline sequentially by 1.5%, something that has not happened since the 1950s, when private debt loads were considerably lighter. Patently, nominal income deflation is not just a theoretical concern — it has arrived in the United States. It necessarily follows that the nearly \$1 trillion federal deficit and the \$166 billion improvement in nominal net exports from a midyear nadir were not sufficient to meet desired net private saving levels in Q4 2008. Unless desired private net saving levels are reduced through a rebound in equity values, a revival of home prices or some other mechanism (and we would note that lower interest rates have not done the job), an even larger fiscal stimulus and trade balance swing will be required to keep the United States out of income deflation. In turn, any reduced risk of income deflation should help lower the odds of a full-blown debt deflation.

Since global trade is contracting as a vicious recession grips other regions as well, exiting only through a U.S. trade swing is highly unlikely even under a sharp dollar depreciation scenario. We, therefore, suspect more of the burden of adjustment will be placed on fiscal policy than ever before. For most investors, that immediately begs the question of who is in a position to purchase a huge issuance of Treasury debt.

TREASURY TROVES

Few investors realize that Treasury holdings were once close to 40% of commercial bank assets. World War II marked huge Treasury issuance with little private borrowing from banks, so naturally their portfolio mix shifted over time heavily toward Treasuries. Now Treasury holdings are less than 1% of commercial bank assets, while commercial bank holdings of reserves at the Fed have surged to 6% of total assets. These reserves are earning next to nothing. They may represent precautionary balances held by banks in the face of uncertainty regarding the size of future loss recognition, but at some point, we can anticipate banks will prefer to “ride the yield curve” and accumulate default-free Treasuries with their cash reserves. Rising Treasury exposures on bank balance sheets have, after all, been characteristic on the way out of every recession of the past five decades.

In addition, the Fed’s own allocation toward Treasuries, which normally have accounted for 60–80% of the central bank’s assets, is down to 20%. The Fed sold much of its Treasury exposure in 2008 to offset the increase in reserves from its rescue operations, but this practice ceased after the Lehman Bros. bankruptcy. Households also show very low allocations to Treasuries, something which could conceivably change after such large shocks to real estate and equity holdings. This suggests even if foreigners refuse to participate in future Treasury

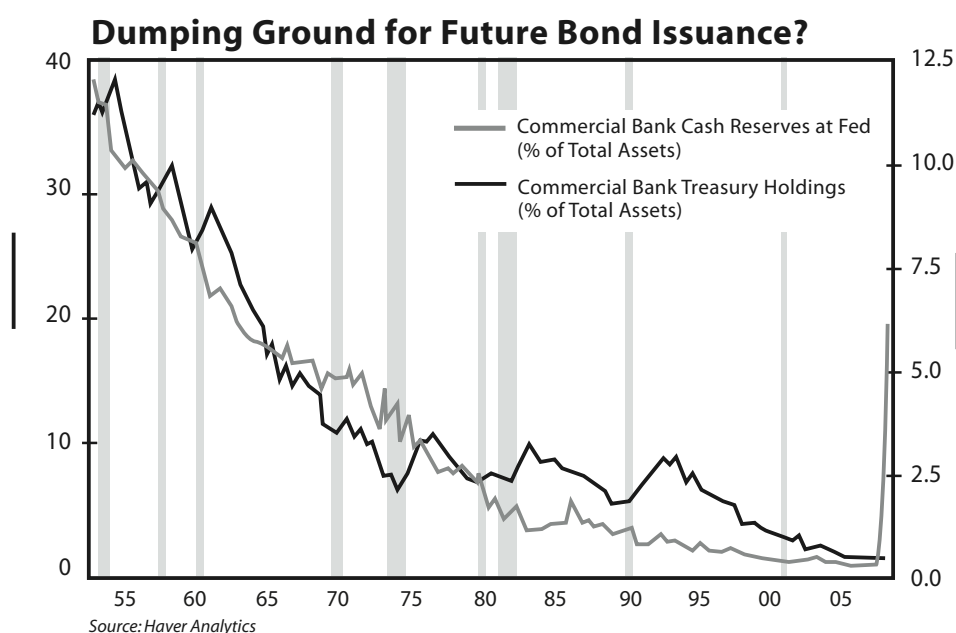
auctions, there is capacity for Treasury issuance to be purchased domestically. Indeed, in recent quarters, both money market mutual funds and broker-dealers have been active purchasers of Treasuries.

The announcement at the March FOMC meeting that the Fed intends to purchase \$300 billion of U.S. Treasuries in the 2–10 year maturity range is indicative of the types of operations we can expect in the future.

In fact, as commercial and central bank Treasury purchases are often associated with an increase in the money supply, the domestic capacity for Treasury bond absorption is theoretically unbounded. When investor and lender liquidity preferences remain extremely high, an expansion of the money stock must also be large if it is to lead to an increase in the prices of less-liquid assets. Treasury purchases by the Fed and commercial banks could thereby cut short the adverse feedback loops related to falling asset prices, including wealth effects on private spending out of income flows.

The risk, of course, is not only the generation of future asset bubbles, but also a flight from the currencies where central banks are aggressive first movers in this direction. In response, central banks may state a willingness to soak liquidity back up in a timely fashion, but their track record leaves much to be desired.

To be clear, Dr. Richebächer did not entirely share the Austrian view that growth in the money supply is by itself



the definition of inflation. Indeed, Austrians like Mises who took the view that any supply of money would be sufficient, since the velocity of money (the number of monetary transactions during a period of time) would vary to accommodate money demand, partially undermined their own theory of inflation. If the velocity of money was that flexible, as perhaps Mises' experience with hyperinflation had revealed, then any quantity of money could be associated with escalating inflation. Rather, Dr. Richebächer found the path between money growth and final product price inflation requires a manipulation of asset prices sufficient to influence private spending decisions. As Dr. Richebächer wrote in his September 2001 letter, "*Broadly speaking, easy money essentially works through easing the financial markets: first, by reducing long-term interest rates, on which most borrowing is based; second, by boosting equity values, thus raising consumer wealth and lowering corporation's cost of equity financing; third, by lowering the value of the dollar, which helps U.S. exports.*" As it stands, the Fed has shown some success only with the first channel of influence, but perhaps after the over \$1 trillion expansion of the Fed's balance sheet proposed in the last FOMC meeting, the tide of liquidity created by the Fed will prove sufficient to drown current liquidity preferences of private investors

SUMMARY AND CONCLUSIONS

Under tremendous pressure from portfolio losses and falling income, the household financial balance has swung dramatically back into surplus. Household debt is shrinking for the first time in decades. We believe Dr. Richebächer would agree these are indications that necessary macroeconomic and financial adjustments are under way. However, the reversal of U.S. household deficit spending is damaging revenue and profit growth for firms here and abroad. As firms react to reduced profitability by reducing employment, household income flows become weaker, thereby requiring sharper cutbacks in consumer spending to achieve any given saving target. Falling incomes also make further reductions in the household debt-to-income ratio problematic. In additions, firms find it harder to shrink their share count, as not only do they have less free cash flow when profits are squeezed, but they also face a reduced ability to take on debt to complete share repurchases. This removes a key support for equity prices. As equity prices fall, an involuntary releveraging occurs as household liability-to-asset ratios rise. These are only a few of the crucial interconnections producing cumulative strains on the private sector as the adjustment process progresses.

Multiple adverse feedback loops, as Chairman Bernanke technically terms the above dynamics, are now entrained. In the absence of a successful effort to manipulate asset prices higher, a reversal in the trade deficit and a deeper fiscal deficit will be required to prevent income deflation from deepening following its onset in the United States during Q4 2008. A falling trade deficit and a rising fiscal deficit will tend to boost private domestic incomes and thereby short-circuit a debt deflation process. As to whether there is a home for the massive Treasury issuance that may be associated with a high fiscal deficit path, record-low allocations to Treasury securities can be found at the Fed, on commercial bank balance sheets and among U.S. households. Should central and commercial bank accumulation of Treasuries lead to a higher money supply, this could prove favorable for stabilizing the prices of less-liquid assets, and so offer a way of breaking some of the adverse feedback loops described herein. Such an accomplishment would come at the risk, however, of creating future asset bubbles, as well as future inflation pressures.

There is some kind of way out of here. The easy way out described above is how we believe escape routes have been fashioned by policymakers in recent quarters. The easy way out fails to address the necessary changes in the underlying structure of production. It may buy time for industries like the auto sector to shrink in a less disruptive fashion, but the easy way out provides little in the way of new incentives to encourage the emergence of new growth industries that will engage in the capital investment required to create new jobs.

As Rothbard reminds us, if history is any guide, the easy way out also appears thick with jokers and thieves, and we believe it may be best to position portfolios to deal with them along the way ahead.